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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 755

ISADORE BLAU, a stockholder of Northwest Airlines, Inc., suing on behalf of himself and all other stockholders similarly situated and on behalf and in the right of Northwest Airlines, Inc.,

Petitioner,

—v.—

ALONZO PETTEYS and C. FRANK REAVIS,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

MARTIN D. JACOBS
Counsel for Respondents
1 Chase Manhattan Plaza
New York, New York 10005

REAVIS & MCGRATH
Of Counsel

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IN THE

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October Term, 1966

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Petitioner,

—v.—

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

Question Presented

Is the conversion, by a non-controlling director, of listed convertible preferred stock into listed common stock of the same issuer a "purchase" of the common stock within the meaning of Section 16(b) of the Securities Exchange Act of 1934 in a case in which all convertible preferred stock outstanding had been called for redemption at a redemption price substantially below the market price of the convertible preferred stock, and the convertible preferred stock and the common stock into which it was convertible were economic equivalents in the market place?

Summary of Bases for Denial of Petition

1. The question presented by the decision below is no longer important since the Securities and Exchange Commission on February 17, 1966 adopted Rule 16b-9, which by its terms exempts from the operation of Section 16(b) of the Securities Exchange Act of 1934 (the "Act") all conversions of an equity security into another equity security of the same issuer. That rule governs all transactions after its date. No similar case can therefore arise in the future. Accordingly, no "special and important reasons" exist for granting the writ.

2. There is no decision of any Court of Appeals in conflict with the decision of the Court of Appeals for the Eighth Circuit in this case. In the one other case presenting the same set of facts, *Ferraiolo* v. *Newman,* 259 F. 2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959), the Court reached an identical result.

3. The decision below is correct.

Statement of Facts

Petitioner seeks review of the decision of the Court of Appeals for the Eighth Circuit denying recovery under the short swing profit recovery provisions of Section 16(b) of the Securities Exchange Act of 1934. The basis of the decision was that conversion of convertible preferred stock into common stock under the circumstances of the case was not a "purchase" within the meaning of that section.

The facts are not in dispute. They were stipulated, and all parties except Northwest Airlines, Inc. ("Northwest") moved for summary judgment.

This case is one of conversion of convertible equity securities (convertible preferred stock) into common stock

of the same issuer after the preferred stock had been called for redemption. The respondents, both directors of Northwest were two of the fourteen directors of that corporation (R. 24a, 25a).[1] They were not in control, either by reason of ownership of stock or otherwise, and held relatively minor percentages of its stock, that of Mr. Petteys amounting to 5,000 shares of the 449,615 shares of the convertible preferred stock outstanding and that of Mr. Reavis amounting to only 1,167 shares of such stock (R. 23a-25a, 27a, 67a). Their holdings of common stock prior to the conversion amounted to 15,000 shares and 4,000 shares, respectively, out of a total of 1,388,459 shares outstanding (R. 22a-24a). All the common and preferred stock in question had been held by them for more than six months prior to the call for redemption (R. 23a, 24a).

The redemption price was only approximately 75% of the market price at the time of the call (R. 26a). The convertible preferred was fully protected against dilution and both the preferred and the common were listed on the same exchange (The New York Stock Exchange) (R. 22a). The result was that the market price of the preferred and the common were at all times in fixed relation to each other in a proportion corresponding with the conversion rate, that is, .9615 of a share of common stock for each share of preferred (R. 28a).

Virtually all the preferred stock was converted prior to the redemption date, the holders of only 70 of the 449,615 shares outstanding at the time of the call failing to convert (R. 27a).

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[1] References are to pages of the record certified to this Court by the Clerk of the United States Court of Appeals for the Eighth Circuit.

The preferred stock was convertible at any time prior to January 1, 1964 (R. 22a). On January 14, 1963 the directors called the preferred for redemption on February 14, 1963. This action was taken by resolution adopted unanimously by the Board of Directors (R. 25a). The two Respondents voted for the resolution. The market price of the common stock was then $36 and that of the preferred stock was about $34 per share (R. 28a). Compared with this market price, the redemption price of the preferred was only $26.18 per share, that is, $26 plus 16.1815 cents for dividends accrued through February 14, 1963 (R. 25a).

All stockholders were immediately notified of the action and, as noted, except for 70 shares, all shares, including those of the Respondents, were converted prior to the redemption date (R. 25a, 26a, 67a). On February 25, 1963, the Board of Directors declared a quarterly dividend on the common stock of 25 cents per share, an increase of 5 cents per share.

Within six months after conversion each Respondent sold common shares in excess of the number of shares he had received upon redemption at prices exceeding the market price at the time of conversion (R. 26a, 27a).

On February 17, 1966, the Securities and Exchange Commission adopted an amendment to Rule 16b-9, 31 Fed. Reg. 3391 (1966), amending 17 C.F.R. 240.16b-9 (1964), exempting from Section 16(b) transactions involving the conversion of a convertible equity security into another equity security of the same issuer. The rule is set forth in the Appendix. It was prospective in application.

The decision in the District Court in the instant case was handed down before the adoption by the SEC of its rule

that no conversion of equity securities is a purchase. In its decision the District Court decided for the Petitioners, holding that all conversions of one stock into another are purchases within the broad language of Section 3(a) (13) of the Act and hence that the facts in the instant case were immaterial.

The Court of Appeals, following *Ferraiolo* v. *Newman, supra,* held that Section 16(b) did not apply to an involuntary conversion involving economically equivalent equity securities, and reversed the decision of the District Court. The Court also made reference to the fact that the SEC has now ruled that no conversion is a purchase, although the Court found it unnecessary to rely on this.

ARGUMENT

1. No Special and Important Reasons Exist for Granting the Writ Since the Question Can No Longer Arise by Reason of Newly Adopted Rule 16b-9.

The Supreme Court denied certiorari in 1959 of a case presenting the identical question presented in this case, *Ferraiolo* v. *Newman, supra, cert. denied,* 359 U.S. 927 (1959). There is even less reason today for consideration of the issue, since the SEC has promulgated a new rule exempting transactions of this nature from the application of Section 16(b) of the Act. The Securities and Exchange Commission on February 17, 1966 adopted an amendment to Rule 16b-9. That rule, with certain exceptions not here pertinent, exempts from Section 16(b) any acquisition or disposition of an equity security upon the conversion of an equity security into another equity security of the same issuer. Thus, any conversion of the type here present which

occurs after February 17, 1966 is, under the terms of the rule, exempt from the operation of Section 16(b).

No special or important reasons exist for consideration by this Court of a question which has been removed from controversy by rule of the Commission. In the circumstances the writ should be denied. *Rice* v. *Sioux City Cemetery*, 349 U.S. 70 (1954); *United States* v. *Abrams*, 197 F. 2d 803 (6th Cir. 1952), *cert. denied*, 344 U.S. 855; *District of Columbia* v. *Sweeney*, 310 U.S. 631 (1939); see Stern, *Denial of Certiorari Despite a Conflict*, 66 Harv. L. Rev. 465 (1953).

2. No Conflict of Decisions Exists.

There is no decision of any United States Court of Appeals in conflict with the decision of this case. No United States Court of Appeals has held a non-controlling insider liable under Section 16(b) of the Securities Exchange Act of 1934 where the convertible security was converted into another, economically equivalent, equity security of the same corporation after all the convertible issue had been called for redemption and the redemption price was below the market price of the convertible security and the corresponding price of the security into which it was convertible. In the only other Court of Appeals case dealing with this fact situation, *Ferraiolo* v. *Newman*, *supra*, the Court reached a result identical with the present case.

The case of *Heli-Coil Corporation* v. *Webster*, 352 F. 2d 156 (3d Cir. 1965), is not a conflicting decision. It did not present the same question. Among the significant differences were these:

1. The convertible securities in that case had not been called for redemption. There was, therefore, no

question of necessity to convert to avoid redemption at a price lower than the market. Thus, the conversion was in effect voluntary. Indeed, only 22% of the outstanding debentures were converted. The conversion did not result from a call affecting all debentureholders but instead was made upon the recommendation of an investment banker to a few holders of the debentures, including the defendant director who had been recommended for election to the Board of Directors by the banker.

2. The convertible securities in that case were debt securities, that is, convertible debentures not convertible preferred stock. Their conversion involved a change from debt status to equity status, with a consequent effect upon the company's balance sheet, borrowing power and equity values.

3. The debentures were not listed, while the stock was. The result was a possible lag in price adjustment, so that the exact economic equivalent which existed in this case and the *Ferraiolo* case, *supra*, was not present in *Heli-Coil*.

These differences were critical, since they presented the Court with the possibility of violation of the purposes of Section 16(b). Indeed, one of the reasons for the conversion in the *Heli-Coil* case was the belief that the elimination from the balance sheet of the debt represented by the converted debentures would increase the value of the common stock into which the debentures were converted. The Court there stated: "This seems to be an instance when a decision to convert could involve speculative or subjective judgment as to trading advantages to be anticipated in holding stock rather than convertible debentures." (352 F. 2d 156, 165 (3rd Cir. 1965).)

In the instant case the Court of Appeals for the Eighth Circuit said in its opinion:

> "If, from an examination of the particular facts, a transaction is of a kind that can possibly lend itself to the speculation encompassed by § 16(b) and falls within the broad definition of 'purchase' and 'sale', it will be so defined. However, if an examination of the facts indicates that there is no possibility of abuse, there is no need to apply a § 16(b) label to the transaction."

It thus is apparent not only that there is no conflict in the decision, but that the Court of Appeals for the Eighth Circuit might, in the *Heli-Coil* case, have reached the same result as that reached in it by the Court of Appeals for the Third Circuit.

3. The Decision Below Is Correct.

The Court of Appeals examined the facts in their relation to the purposes of the statute. In this it was applying the time-honored function of the Courts to interpret the Act in a manner to effectuate its purpose. There is nothing in the legislative history of the Act or in the Act itself to suggest that Congress intended to exclude the Courts from their proper function.

The Court did not attempt to determine the subjective intention of the respondents. What it did was to determine, viewing the facts objectively, that there was no possibility of the abuse sought to be reached by the Act. Accordingly, the Court said that "there is no need to apply a § 16(b) label to the transaction". The holding is manifestly cor-

rect. It involves a set of facts identical with that in *Ferraiolo* v. *Newman, supra*, and follows that authority.

Both the rationale of the decision of the Circuit Court and the result are confirmed by the SEC's newly promulgated Rule 16b-9 which has as its premise the finding by the SEC that conversion transactions of the type here present are not comprehended within the purposes of Section 16(b). This is objective confirmation based upon the Commission's experience that this type of transaction does not have within it the seeds of abuse. The decision was clearly correct.

CONCLUSION

The petition seeks review of a decision that (i) presents no special or important reasons for review by this Court, (ii) is not in conflict with a decision of the Court of Appeals of any other circuit, and (iii) is clearly correct. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted,

MARTIN D. JACOBS
Counsel for Respondents
1 Chase Manhattan Plaza
New York, New York 10005

REAVIS & MCGRATH
Of Counsel

December 7, 1966

APPENDIX

Rule 16b-9 Under the Securities Exchange Act of 1934
(Effective February 17, 1966)

Exemption from section 16(b) of transactions involving the conversion of equity securities.

(a) Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of section 16(b) of the Act: *Provided, however,* That this section shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon conversion, or (2) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion (otherwise than in a transaction involved in such conversion or in a transaction exempted by any other rule under section 16(b)) within a period of less than 6 months which includes the date of conversion.

(b) For the purpose of this section, an equity security shall not be deemed to be acquired or disposed of upon conversion of an equity security if the terms of the equity security converted require the payment or entail the receipt, in connection with such conversion, of cash or other property (other than equity securities involved in the conversion) equal in value at the time of conversion to more than

15 percent of the value of the equity security issued upon conversion.

(c) For the purpose of this section, an equity security shall be deemed convertible if it is convertible at the option of the holder or of some other person or by operation of the terms of the security or the governing instruments.